IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1977

No. 77-465

CHANDLER G. KETCHUM and HAROLD S. BIGLER,

Petitioners,

v.

EDWARD J. GREENE, HARRY B. HILTZ, JR., JOHN C. McCUTCHEN, DAVID G. ROOF, WILLIAM M. WAUGH, JR., RONALD B. LIVINGSTON, WILLIAM M. STEELE, and BABB, INC.,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF IN OPPOSITION TO CERTIORARI

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QUESTION PRESENTED

Whether the propriety of the termination of employees of a private, closely-held corporation should be examined under section 10(b) of the Securities Exchange Act of 1934?

COUNTER STATEMENT OF THE CASE

Petitioners Ketchum and Bigler, plaintiffs at trial and appellants below, were directors of Babb, Inc. ("Babb") and were employed as chairman of the board and president of Babb until April 23, 1976 at which time they were not reelected as officers and their employment terminated (28a-32a).[1] The individual respondents constituted the majority of the board of directors of Babb (54a). Babb is a closely held, private corporation organized under the laws of Pennsylvania and engaged in the insurance brokerage business (27a). Petitioners Ketchum and Bigler filed a Complaint in

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1. The citations designated by "a" are to portions of the appendix attached to the Petition for Writ of Certiorari. Citations to the Stipulation of Facts No. 1 are to the paragraph of said Stipulation and the portion of the appendix where it is reproduced. Citations designated by "aa" are to portions of the appendix submitted below to the Third Circuit Court of Appeals and transmitted to this Court as part of the record.

the United States District Court for the Western District of Pennsylvania alleging that their termination violated section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. § 78j(b) (1970)), SEC Rule 10b-5 (17 C.F.R. § 240.10b-5 (1977)) promulgated thereunder and certain pendent claims under Pennsylvania law (34a-35a). Petitioners sought as relief, inter alia, to remove the respondents from office, to be reinstated as chairman of the board and president of Babb and to enjoin respondents from disturbing petitioners' management of Babb (34a). Petitioners also alleged that they suffered damages because their stock is subject to a Stock Retirement Agreement executed by petitioners and Babb in 1968 which requires them to sell and Babb to buy their Babb stock at $2.63 per share upon termination of their employment (32a, 33a). All stock of Babb is held by its employees and is subject to such agreements (Stip. ¶ 25, 6a). Petitioners alleged that their Babb stock was worth $15.00 per share. After trial on petitioners' motion for a permanent injunction, the district court dismissed the Complaint for failure to state a federal claim because the "in connection with" element was lacking (35a, 46a). In so doing, the district court found based on the evidence introduced at trial that $2.63 per share was not a wholly inadequate consideration for petitioners' Babb stock (42a-43a, 48a-49a). The

Third Circuit Court of Appeals affirmed the dismissal on the grounds that the "in connection with" element was lacking (68a).

Although many of the facts surrounding the instant controversy were stipulated by the parties (1a), petitioners' "Statement of the Case" contains unsupported assertions of fact regarding the nominating committee and ignores the fact finding made against them concerning the validity of the issuance of 7,500 shares of stock to respondent Roof.

Background

Babb had lost money for at least three years preceding the 1976 elections (29a). These losses resulted in the directors and officers having to give up bonuses, medical reimbursement plans and other benefits (T. 154, 191aa).[2] The respondents believed these losses were due to petitioners' wasteful and counterproductive diversion of corporate resources into unrelated losing ventures and their repeated disregard of the board in the formulation of important corporate decisions (29a). Respondents at various

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2. Due to the difficulty of reading the transcript of the trial which was printed in the appendix submitted to the Third Circuit Court of Appeals, references are to the pages of the transcript which has been sent to this Court as part of the record and to the pages of said appendix where the transcript was reproduced.

times communicated many of their criticisms of petitioners' management to petitioners and petitioner Ketchum was aware of many of them as early as 1973 (T. 130-T. 141, 167aa-178aa). In late 1975 and early 1976 several of the individual respondents subsequently joined by the others, discussed among themselves the possibility of removing petitioners as officers and employees of Babb (Stip. ¶ 36-37, 9a).

The Nominating Committee and the Board Meetings

On March 8, 1976 the board of directors appointed a three man committee to nominate at the upcoming annual meeting of shareholders individuals for the position of directors and to nominate at the organizational meeting of the board, which was to follow the annual shareholders' meeting, individuals for positions as officers (Stip. ¶ 55, 18a). The nominating committee's nominees for officers have usually, but not always, been elected by the board of directors (Stip. ¶ 59, 19a; T. 83-84, 120aa-121aa; T. 174, 211aa). This committee consisted of petitioner Bigler, respondent Waugh and Mr. Whitridge (Stip. ¶ 55, 18a).

The nominating committee met on March 8, 1976 and agreed to recommend for nomination at the shareholders' meeting as directors the eleven incumbents and agreed to recommend for nomination at the organization meeting of the board as officers the incumbent officers (Stip. ¶ 56, 57, 18a). The

nominating committee held no further meetings after March 8, 1976 except that the members agreed by telephone to add an additional nominee for a newly created vice presidency (Stip. ¶ 57, 18a). By April 6, 1976 all of the individual respondents, including respondent Waugh who served on the nominating committee, had agreed that in the best interests of Babb they would not elect petitioners to be officers of Babb at the organization meeting of the board of directors which was to follow the annual shareholders' meeting (Stip. ¶ 44, 10a; T. 177, 214aa).

On April 23, 1976 the following meetings were held at Babb: a meeting of the board was held prior to the annual meeting of shareholders, the annual meeting of shareholders was then held, and following the shareholders' meeting an organizational meeting of the board was held (Stip. ¶ 57, 62, 68, 18a, 20a, 23a).

Petitioners contend that the nominating commitee report for officers was submitted to the board at its first meeting on April 23, 1976 and that respondents "represented to the thirteen shareholders present at the directors' meeting that they would vote for the officers nominated ... including petitioner Ketchum for chairman and petitioner Bigler for president." Petition for Writ of Certiorari at 7 (emphasis added). Petitioners repeat in varying manner the substance of this allegation on pages 8, 9

and 10 of their Petition for Writ of Certiorari. Petitioners contended at trial that the nominating committee's report was presented at the first meeting of the board (T. 38, 74aa). Respondents denied that it was introduced at that meeting (T. 196, 233aa). The district court made no finding on this issue. The opinion of the Third Circuit Court of Appeals states that the report was presented at the first meeting of the board but does not otherwise indicate that the appellate court intended to resolve this issue. In any event, there was no evidence introduced at trial, either by way of the stipulations or otherwise, which even suggests that the individual respondents ever represented to the board that if reelected by the shareholders they would vote as directors for the officers nominated by the nominating committee. Similarly, there is not a scintilla of evidence in the record which suggests that the members of the board ever entered into any oral or written agreement pursuant to which they would, if reelected by the shareholders, vote as directors for the officers nominated by the nominating committee. The record establishes only that the individual respondents revealed their intentions only to themselves and to two other shareholders, Mr. Parks and Mr. Williams, prior to the organizational meeting, that the individual respondents purposely did not disclose their intentions

to petitioners or to any other shareholders (except Mr. Parks and Mr. Williams) prior to the organizational meeting and that petitioners assumed that they would retain their positions with Babb. Petitioners cite in support of their allegation their appendix at 19a-21a. None of the paragraphs of the Stipulation of Facts No. 1 which appear on those pages states that the individual respondents ever told petitioners or the entire board whom they would vote for as officers of Babb, that all of the directors ever agreed among themselves to vote for the nominating committee's nominees or that petitioners ever asked the individual respondents whom they would vote for as officers if respondents were reelected as directors.

At the annual shareholders' meeting, the shareholders unanimously reelected the eleven incumbent directors, including the seven individual respondents (Stip. ¶62, 20a). Other than their own proxies, the individual respondents only solicited the proxies of two shareholders, Mr. Parks and Mr. Williams, who were informed of the individual respondents' intentions prior to the annual shareholders' meeting (Stip. ¶ 46, 61, 64, 11a, 20a, 22a).

At the organizational meeting of the reelected board, the nominating committee's recommendations for individuals for the offices of Babb were nominated (Stip. ¶68, 23a). However, respondent Livingston then

nominated a slate of individuals, which did not include plaintiffs, for the offices of Babb (Stip. ¶68, 23a). The candidates nominated by respondent Livingston were elected by vote of the seven individual respondents against the two petitioners and two others (Stip. ¶69, 23a). The board then adopted by similar seven against four vote a resolution terminating petitioners' employment (Stip. ¶ 70, 23a). Pursuant to the stock retirement agreement, the board then adopted a resolution to repurchase petitioners' stock at the contract price, $2.63 per share (Stip. ¶71, 24a).

Shareholdings in Babb

Petitioners allege that the individual respondents "thwarted the will of the majority" of Babb's shareholders. Petition for Writ of Certiorari at 10-11. In support of this contention, petitioners reproduce paragraphs 63 and 64 of the Stipulation of Facts No. 1. Paragraph 64 sets forth the shareholdings (228,100 shares) of five of the seven individual respondents and of Mr. Parks and Mr. Williams, who had been informed of respondents' intentions and had entered into a vote pooling agreement with and given their proxies to the individual respondents.[3] However,

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3. The vote pooling agreement and proxies are described in paragraph 46 (11a) of said Stipulation.

paragraph 64 contains a footnote to the effect that it shall not contradict paragraphs 51 (17a) and 66 (22a) of said Stipulation. Paragraph 51 states that the sixth respondent, Mr. Roof, whose name does not appear in the list reproduced by petitioners, was issued 7,500 shares of stock on April 6, 1976. This footnote was added because of the factual dispute over whether or not these shares were validly and lawfully issued to respondent Roof prior to the annual shareholders' meeting (compare T. 29-35, 65aa-71aa with T. 78-81, 115aa-118aa). In footnote 1 of its opinion (30a-31a) and in its order of July 14, 1976 (46a) the district court held that respondent Roof had been validly and lawfully issued these 7,500 shares. The Third Circuit Court of Appeals did not disagree with this finding (53a). Adding these 7,500 shares to the 228,100 shares set forth in paragraph 64 results in the holders of 235,600 shares having known prior to the annual shareholders' meeting of the individual respondents' intentions. Since Babb had 470,845 shares of stock outstanding at the annual meeting of shareholders (30a), the holders of a majority (50.03 percent) of Babb's stock knew prior to the annual meeting of shareholders of the individual respondents' intentions regarding

petitioners.[4]

ARGUMENT

I. THE DECISION BELOW ACCORDS WITH THE DECISIONS OF THIS COURT.

Petitioners claim that the decision below violates the holding contained in Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971). The opinion of the Third Circuit Court of Appeals distinguished Bankers Life on three separate grounds which need not

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4. Footnote 2 of the appellate court's opinion (53a) as well as the text of it (54a) correctly notes that the individual respondents, including respondent Roof, owned slightly less than 50 percent of the outstanding stock. To be exact, the individual respondents owned 229,000 shares or 48.6 percent of the outstanding stock (30a-31a). However, the addition of the shareholdings of Mr. Parks and Mr. Williams, who signed vote pooling agreements and gave proxies to the individual respondents, to the stock owned by the individual respondents results in the individual respondents' controlling at the annual meeting 235,600 shares of Babb stock or 50.03 percent of the outstanding stock. The 47.8 percent figure set forth on page 5 of the Petition for Writ of Certiorari represents the shareholdings of only five of the individual respondents and ignores the stock held by respondent Roof and the shares held by Mr. Parks and Mr. Williams.

be repeated here. Furthermore, the district court concluded that the reliance and materiality tests for the "in connection with" element of Section 10(b) (see Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972)) were not met, because petitioners were contractually obligated to resell their shares to Babb and lacked any voluntary choice in this resale (37a-40a).

The decision below also accords with the very recent decision of this Court in Santa Fe Indus. Inc. v. Green, ____ U.S. ____, 45 U.S.L.W. 4317 (March 23, 1977), which held that section 10(b) did not reach a mere breach of fiduciary duty which occurred in connection with a securities transaction. In reaching that decision, this Court reasoned:

> "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden. As the Court stated in Cort v. Ash, supra, 'Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.'"
> 45 U.S.L.W. at 4322 (Emphasis original).

As both the district court (42a-45a) and the appellate court (64a-65a) noted, the nub of the petitioners' claim deals with the internal conduct of Babb, which was regulated by Pennsylvania state law[5]. Section 10(b) was not intended by Congress to be used to create federal standards of fair play for terminating incompetent management in private closely-held corporations.

II. THE DECISION BELOW ACCORDS WITH THE DECISIONS IN OTHER CIRCUITS.

Petitioners contend that the decision below conflicts with decisions rendered in the Second, Fifth and Seventh Circuits. However, they are unable to cite any case law containing facts even remotely similar to the subject matter of the instant litigation -- the resale of stock to a corporation upon an employee's termination of employment pursuant to stock repurchase agreements.

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5. The district court noted that the respondents' actions appeared to comply with Pennsylvania corporate law (39a).

In the Second Circuit, petitioners rely principally on Vine v. Beneficial Finance Co., 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967). Vine arose in the context of a motion to dismiss a complaint on the ground that the plaintiff lacked standing. 374 F.2d at 633 ("narrow question is ... whether appellant is a seller"). Thus, while Vine established the forced seller exception to the purchaser/seller standing requirement of section 10(b) (see Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)), the court never squarely addressed the "in connection with" element. Furthermore, Vine is distinguishable from the instant litigation because Vine dealt with the construction of a complaint rather than with a determination based on the evidence adduced at a trial. The dictum cited by petitioners dealt with Beneficial's argument that plaintiff lacked standing because the only alleged fraud committed by it was against those class A shareholders who, unlike plaintiff, had sold their stock to Beneficial under the tender offer. It was conceded for purposes of the motion to dismiss that actionable fraud had caused these shareholders to sell their stock. Thus, the cited dictum deals with the ability of a plaintiff to assert the nexus concededly present in the sales of stock by the other class A shareholders. In the instant litigation, no such nexus exists which petitioners can borrow.

Petitioners also cite at page 23 Drachman v. Harvey, 453 F.2d 722 (2d Cir. 1972) (en banc), although they provide no explanation of it. Drachman involved a shareholder's derivative complaint seeking to recover damages for an alleged improvident corporate redemption of convertible debentures which was undertaken to prevent their conversion. Like Vine, Drachman did not consider the "in connection with" element in terms of specific facts adduced at trial. Drachman is also distinguishable from the instant litigation because Babb, unlike the corporation in Drachman, was contractually obligated under the stock repurchase agreements to repurchase petitioners' stock upon termination of their employment. Babb had no choice in the securities transaction.

Petitioners neglect to call this Court's attention to the Second Circuit decision of Ryan v. J. Walter Thompson Co., 453 F.2d 444 (2d Cir. 1971) (per curiam), cert. denied, 406 U.S. 907 (1972), which was decided after Vine and dealt with facts similar to those presented here.[6] In Ryan a former corporate officer and director sued under section 10(b) when the

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6. Judge Smith who dissented in the Drachman panel decision and subsequently wrote the en banc decision reversing it was a member of the Ryan panel.

corporation repurchased his stock pursuant to a buy back agreement shortly before it went public. The buy back agreement provided that upon termination of employment the corporation had the option to repurchase the former employee's stock. When the plaintiff reached the corporation's mandatory retirement age of 65, the corporation agreed to retain him for another year. At the end of that year, the corporation did not further retain him. Ryan gave the corporation a one year extension of its option. During this extension the corporation exercised its option. The Second Circuit held that no claim under section 10(b) existed, because Ryan was contractually obligated to sell his stock to the corporation. Two district court decisions of this year in the Second Circuit have followed Ryan. In Weissman v. Smoler Bros., Inc., ____ F. Supp. ____, [1976-1977 Transfer Binder] CCH Fed. Sec. L. Rep. ¶95,878 (S.D.N.Y. 1977), a terminated employee alleged that section 10(b) was violated by his company's repurchase of his stock pursuant to a repurchase agreement which gave the company an option to purchase any employee's stock upon his termination. The employee alleged that certain officers committed actionable fraud by misrepresenting to him that he would continue to be employed as an executive and by failing to disclose their intent to terminate his employment. The court

held under the reliance and materiality tests for the "in connection with" element that such element was lacking, because the contract required him to sell his stock. To like effect is Keating v. BBDO Internat'l, Inc., ____ F. Supp. ____, [Current Transfer Binder] CCH Fed. Sec. L. Rep. ¶96,124 (S.D.N.Y. 1977).

Petitioners also suggest that the decision below contradicts a dictum in Smallwood v. Pearl Brewing Co., 489 F.2d 579 (5th Cir.), cert. denied, 419 U.S. 873 (1974). Smallwood dealt with a merger of two corporations and the exchange of shares of the constituent company for those of the survivor. In the dictum cited by petitioners the court stated:

> We do not hazard an opinion as to the outer limits of this test. It is important that the standard be fleshed out by a cautious case-by-case approach.
> 489 F.2d at 595.

Thus, the Smallwood court confined its dictum to the unique facts present therein and it is not contradictory to the decision below. The court below followed the Smallwood approach and decided the instant litigation on its unique facts, which are totally unrelated to those present in Smallwood (59a).

The petitioners' final argument is that the decision below contradicts Jannes v. Microwave Communications, Inc., 461 F.2d 525 (7th Cir. 1972).

Jannes dealt merely with the examination of the pleadings in a shareholder's derivative complaint rather than with the application of the "in connection with" element to facts adduced at trial. The court held that the complaint adequately alleged this element in regard to two transactions: first, it alleged that the corporation sold certain of its assets for only 25 percent of their value to the defendants, who were officers and directors of it; and, second, these insiders caused the corporation to issue to themselves its stock for an inadequate consideration. 461 F.2d at 529. These allegations are clearly distinguishable from the instant litigation, since Babb neither sold any of its assets nor issued any of its stock to the respondents for an inadequate consideration. As with the other cases relied upon by petitioners, the Jannes court never considered this element in relation to the termination of an employee's employment and a resultant resale of his stock to his corporate employer. The only decision in the Seventh Circuit which treats this subject matter is Blackett v. Clinton E. Frank, Inc., 379 F. Supp. 941 (N.D. Ill. 1974) which was relied upon by the district court below (44a) and which held that an officer whose employment was terminated lacked any claim under section 10(b), because he was obligated by a prior stock purchase agreement to resell his shares to the corporation.

In St. Louis Union Trust Co. v. Merrill Lynch Pierce Fenner & Smith, Inc., ___ F.2d ___, [Current Transfer Binder] CCH Fed. Sec. L. Rep. ¶96,151 (8th Cir. 1977), the Eighth Circuit recently examined this element in relation to stock repurchase agreements which operate upon termination of employment and followed the decision below.

CONCLUSION

The decision below based on its own peculiar facts clearly accords with this Court's Bankers Life decision. It also accords with all of the decisions from the other Circuit Courts which have treated the mandatory resale by a terminated employee of his stock back to his corporate employer pursuant to a stock repurchase agreement which required such resale upon his termination of employment. Section 10(b) should not be the vehicle for examining the propriety of discharges of employees in closely held, private corporations. The instant petition should be denied.

Respectfully submitted,

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